Supreme Court, U.S.
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No.

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1993

JOHN MARTIN-MUSUMECI,
Petitioner,
vs.
LAW OFFICES OF HERBERT HAFIF
PENSION AND PROFIT SHARING PLAN,
Respondent.

PETITION FOR WRIT OF CERTIORARI

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64 pp

QUESTIONS PRESENTED

1. Is it just and proper for the United States Court of Appeal for the Ninth Circuit to render an unpublished decision concerning the interpretation of a statute of the Uniform Commercial Code in order to avoid having that decision become precedent where that decision involves an unsettled area of commercial law of great importance and is directly contrary to the express language of the statute and to the intent of its drafters.

2. Under Section 9505(2) of the Uniform Commercial Code, can a party "strictly foreclose" on a general intangible?

LIST OF PARTIES

Petitioner: John Martin-Musumeci, an individual.

Respondent: Law Offices of Herbert Hafif Pension and Profit Sharing Plan, an ERISA qualified pension plan maintained by the Law Offices of Herbert Hafif, a business entity, form unknown.

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PETITION FOR WRIT OF CERTIORARI

STATEMENT OF JURISDICTION

This petition for a writ of certiorari is based upon an unpublished decision of the United States Court of Appeals for the Ninth Circuit which was entered on March 10, 1994. The jurisdiction of the United States Supreme Court is invoked under 28 U.S.C. Section 1254(1) and Rule 10.1(a) of the Rules of the Supreme Court of the United States in that, in rendering an unpublished decision as to the meaning of a statute in an unsettled area of great importance to commercial law, the United States Court of Appeal for the Ninth Circuit has "so far departed from the accepted and usual course of judicial proceedings, or sanctioned such a departure by a lower court, as to call for an exercise of this Court's power of supervision."

STATUTES INVOLVED

Uniform Commercial Code Section 9-505(2) (West Pub. Co. 1994):

> In any other case involving consumer goods or any other collateral a secured party in possession may, after default, propose to retain the collateral in satisfaction of the obligation. Written notice of such proposal shall be sent to the debtor if he has not signed after default a statement renouncing or modifying his rights under this subdivision. In the case of consumer goods no other notice need be given. In other cases notice shall be sent to any other secured party from whom the secured party has received (before sending his notice to the debtor or before the debtor's renunciation of his rights) written notice of a claim of an interest in the collateral. If the secured party receives objection in writing from a person entitled to receive notification within 21 days after notice was sent, the secured party must dispose of the collateral under Section 9-504. In the absence of such written objection the secured party may retain the collateral in satisfaction of debtor's obligation.

I.

STATEMENT OF THE CASE

A. Background:

On July 11, 1984, Herbert Hafif, an attorney, made a loan to Debtor, John Martin-Musumeci ("Debtor"), who was then his client, in the amount of $350,000. This loan was made out of funds held by the Herbert Hafif Pension and Profit Sharing Plan ("Hafif"). Debtor executed a note in favor of Hafif, secured by a two percent interest of the undivided beneficial interest in the Marriner Note Trust ("Trust").

The Note provided that in the event Debtor failed to make any interest installment payment when due, Hafif, within 90 days of making a written demand for payment, could sell the two percent interest in the Trust ("2 Points"). The Note provided that if the 2 Points were not sold within the 90 day period, then "full title to said security shall transfer to the Holder [Hafif] and shall be deemed full satisfaction of the entire obligation; I [Debtor] shall not be liable for any real or alleged deficiency." As an alternative remedy, the Note provided Hafif with the right to convert one-half of one percent of the interest in the Trust as repayment.

In a letter dated October 11, 1984, an employee of the trustee of the Marriner Note Trust acknowledged Hafif's security interest in the 2 Points.

Hafif sent Debtor a letter dated March 13, 1985 stating that Hafif was accelerating payment of the loan pursuant to the terms and conditions of the Note. The letter stated that: "[w]e certainly do not wish to exercise our right of conversion." However, the letter made no reference whatsoever to any action Hafif intended to take with respect to the 2 Points.

In a letter from Hafif to Debtor dated August 13, 1985, Hafif notified Debtor that Hafif: ". . . has foreclosed on the security." Further, Hafif stated in the letter that "[w]e deem the foreclosure final with title to the security vested in the Pension Plan." This letter was the first notice that Debtor received which actually stated that Hafif had elected to retain the 2 Points in satisfaction of the Note but it did not provide Debtor with any opportunity to object to this retention but rather presented it as a fait accompli.

Upon receipt of the August 13, 1985 letter, Debtor immediately informed Hafif that he objected to the "foreclosure" of the 2 Points as provided in the letter. In a letter

from Hafif's employee to Debtor dated August 25, 1985, Hafif's employee acknowledged that Hafif had received Debtor's objection, stating that: "[Hafif] was a little bit furious when you claimed that he [Hafif] hadn't properly foreclosed.... Now that you [Debtor] have given up on that idea and agreed that the plan owns the stock, he's [Hafif's] given you the right to get it back." The letter also stated: "[Hafif] is now the full owner of the 2 Points," and advised Debtor that he could repurchase the 2 Points from Hafif for the principal and interest due.

B. Bankruptcy Action:

In 1988, Debtor filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. The bankruptcy was originally filed in Hawaii but was subsequently transferred to the Northern District of California. On July 5, 1990, Debtor brought an adversary proceeding against Hafif, Adv. No. 4-90-0241AT (later consolidated with Adv. No. 4-90-0247-AN), seeking to recover the 2 Points on the basis that Hafif had violated the California Commercial Code in foreclosing on the 2 Points and retaining it in lieu of the amount due under the Note without complying with the requirements of Section 9504 and Section 9505 of the California Commercial Code.

On August 30, 1991, Hafif prevailed at trial before the Honorable Randall J. Newsome, Bankruptcy Judge United States Bankruptcy Court for the Northern District of California and a final judgment was filed on September 3, 1991 ("Judgment"). In ruling in Hafif's favor, the Bankruptcy Court stated that, while the collateral was a general intangible, and was thus not susceptible to possession in the usual sense, Hafif's receipt of an acknowledgment of its security interest in the collateral from the trustee of the Trust was sufficient to constitute a constructive possession and that this constructive possession was all that was needed for

Hafif to strictly foreclose under Section 9-505(2) as that section did not affirmatively exclude general intangibles from its reach. The Bankruptcy Court also expressly found that the collateral for the Note (the 2 Points) had a value of $1,400,000 at the time of the purported "strict foreclosure"—in other words, well in excess of the amount Hafif claimed under the Note: $350,000. Debtor unsuccessfully moved to alter the Judgment under Bankruptcy Rule 9023 and thereafter timely appealed to the District Court.

C. The District Court Affirms In An Unpublished Order:

The District Court's jurisdiction was founded upon 28 U.S.C. Section 158(a) and Bankruptcy Rule 8001(a). On July 30, 1992, the Honorable Barbara A. Caulfield, Judge of the United States District Court for the Northern District of California ("District Court"), issued an order affirming the Judgment ("Order") on the bases of both of the Bankruptcy Court's findings: that constructive possession existed and sufficed *and* that Section 9-505(2) in fact allowed for strict foreclosure of general intangibles. This Order was entered on July 31, 1992, but was never published, and Debtor appealed on August 27, 1992.

D. The Ninth Circuit Also Issues an Unpublished Decision:

Appellate jurisdiction in this action was founded upon 28 U.S.C. Section 158(d), providing courts of appeal with jurisdiction to hear appeals from final decisions, judgments and orders of district courts entered under Section 158(a) (governing appeals from final bankruptcy court decisions, judgments and orders).

On March 10, 1994, the Ninth Circuit, over a dissent by Judge Noonan, issued an *unpublished* memorandum opinion affirming the Order ("Memorandum"). The majority in this Memorandum stated, in pertinent part, that, while they

agreed that a general intangible cannot be possessed for purposes of Section 9-505, they found an exception where there has been an acknowledgment of the security interest by a third party trustee. In dissent, Judge Noonan observed that since, as the majority acknowledged, a general intangible cannot be possessed, then it cannot be subject to strict foreclosure under Section 9-505.

II.

ARGUMENT

1. It Is Unjust And Improper For A Court Of Appeal To Decline To Publish A Decision In An Important, Unsettled Area Of Statutory Interpretation In Order To Avoid That Decision Becoming A Precedent:

The appellate courts function not only to rule on cases affecting individual parties, but to set precedent affecting the law within an entire circuit. Thus, a decision of a Court of Appeals, and the rationale on which it is based, is of interest to all of society. With such a great responsibility, it is imperative that when faced with a decision of public importance, an appellate court not only make society aware of its decision, but also publish the rationale of the decision. This is particularly true where, as here, there is a dissent which goes to the heart of the court's decision.

A. By Failing To Publish The Decision Below, The Ninth Circuit Is Shirking Its Judicial Duty:

Under Ninth Circuit Rule 36-1, all opinions are to be published but memoranda are not. Thus, the only way for the Majority to *avoid* having its decision published was for it to designate that decision as a "memorandum." Considering the criteria for designating a decision as an "opinion," as set

forth by Ninth Circuit Rule 36-2, the instant decision clearly should have been designated as an "opinion":

> A written, reasoned disposition shall be designated as an OPINION only if it:
>
> (a) Establishes, alters, modifies or clarifies a rule of law, or
>
> (b) Calls attention to a rule of law which appears to have been generally overlooked, or . . .
>
> (d) Involves a legal or factual issue of unique interest or substantial public importance . . .

A decision needs to meet only one of these criteria to warrant being published. The Memorandum here meets each of these conditions as it marks a dramatic departure from the statutory language and general interpretation of Section 9-505, either because it is a new rule or a generally overlooked old rule, and impacts a broad range of commercial transactions and would thus be of great interest and concern to the business community.

However, by using the designation "Memorandum," the Majority has ensured that its decision will neither be seen nor cited by other members of the business community. *See* Ninth Circuit Rule 36-3.

As Gilbert S. Merritt, Jr., the Chief Judge of the Court of Appeal for the Sixth Circuit, recently stated, in discussing his decision to reverse the Sixth Circuit's ban on the citation of unpublished opinions: "The law needs to be visible to the public, and judges need to be accountable to the public, ..." Richard C. Reuben, *New Cites For Sore Eyes*, ABA Journal, June, 1994, at 22 (quoting Judge Merritt). When an appellate court fails to publish its opinion for the public to read and critique, it has failed in this duty. The result is often an opinion that is not well reasoned, and a ruling that is simply incorrect. As other noted commentators

have recognized: "The danger here is that the decision not to publish will affect the reasoning or even the result." William L. Reynolds & William M. Richman, *An Evaluation of Limited Publication in the United States Courts of Appeals: The Price of Reform,* 48 U. Chi. L. Rev. 573, 581 (1981) [hereinafter, Limited Publication].

The perfunctory analysis of the Majority in the Ninth Circuit's Memorandum here hardly serves the goals expressed above; to the contrary, it reinforces the need for those goals by at least suggesting that either the Ninth Circuit issued a result-oriented opinion which it knew to be contrary to the law and public policy, or that it issued a significant ruling which changed the rules of conduct in an important area of commercial law — and which thus would have deserved a full, well-reasoned opinion to guide parties and their counsel in future business dealings and litigation. Unfortunately, the likelihood that it was the former is increased by what little analysis is provided.

Although the Majority in the Ninth Circuit's Memorandum conceded that an essential element of strict foreclosure under Uniform Commercial Code Section 9-505(2) is that a secured party must be in possession of the collateral, and went on to recognize that the collateral at issue here was a general intangible which, by definition, could not be possessed, nevertheless the Majority blithely went on to find that the requirement of possession was satisfied here. Then, having taken this significant and unprecedented step, which had the potential to completely change the general understanding and application of this statute in the business world, the Majority declared the Memorandum to be "not appropriate for publication." By the paucity of its analysis, and by its declining to have this Memorandum published, the Majority seems to have simply been creating a one-time exception to the statute, which it did not want others to have

resort to as the Ninth Circuit itself believed that it was bad law.

The result of this judicial activism is threefold: First, it undermines the purposes of the Uniform Commercial Code, as discussed in the next section. Second, it usurps the power and duty of the state legislature to adopt and/or draft legislation in the manner it sees fit. Third, depending upon the Majority's reasons for issuing this unpublished Memorandum, it either a) disregards the rights of Petitioner to a fair and well reasoned decision based upon the law, or b) by placing such a decision away from public scrutiny, deprives other business people of a clear understanding of what the Ninth Circuit believes to be the proper interpretation of the law in this area.

Had the Ninth Circuit been required to publish the decision, along with its incisive dissent, thereby subjecting it to public review and criticism, the Majority would have been forced to analyze the issues more thoroughly, and would have either been constrained from issuing a result-oriented opinion which was unsupported by the law, or issued a seminal opinion in this field which should have been published. Instead, the Majority hid its actions behind the shield of nonpublication.

This approach allowed the judges to avoid doing their jobs, relieving them of their responsibility to approach such important issues with the intense thought, zeal, and intellectual effort that they would put forward in a published opinion. A decision made in this manner must be reviewed by this Court to insure that the issues involved were adequately addressed, and to enable this Court to provide guidance to the federal courts as to which opinions can and cannot be certified for nonpublication.

B. Nonpublication Of Decisions Should Be Strictly Limited To Noncontroversial Decisions That Do Not Establish Unique Rules Of Law:

By electing not to publishing the majority and dissenting opinions in the instant case, the Ninth Circuit is disregarding the rationale behind limiting publication of opinions. Commentators have discussed this purpose:

> First are the stated premises of limited publication, which is a treatment supposedly reserved for cases that do not implicate the lawmaking function of the court — routine, uncontroversial cases. Cases that contain dissents or concurrences are, by definition, controversial; . . . Accordingly, few decisions with separate opinions should go unpublished.

Limited Publication, at 612.

In the present case, there is a separate opinion. In his dissent, Judge Noonan readily recognized the flaw in the majority opinion's reasoning: "[a]s the disposition of the court acknowledges, a general intangible cannot be possessed. As possession was necessary under California law for foreclosure, no foreclosure occurred. I would reverse." This reasoning could not be more clear. It takes the plain meaning of the statute and applies it to the facts of the case. Unfortunately, the majority refused to show such judicial restraint. Judge Noonan's dissent goes to the heart of the majority's decision and shows that the opinion is anything but routine or uncontroversial and, as such, it should have been published.

It has also been noted that "[a] court might also use the cloak of nonpublication to avoid the task of reconciling arguably inconsistent decisions." William L. Reynolds & William M. Richman, *The Non-Precedential Precedent — Limited Publication And No-Citation Rules In The United States Courts Of Appeals*, 78 Colum. L. Rev. 1167, 1200

(1978). In the present case, the Ninth Circuit has gone one step further by using the cloak of nonpublication to avoid the task of reconciling the internal inconsistencies of its Majority opinion. The Majority, while recognizing the requirement of Section 9-505(2), that a secured party be in possession of the collateral *before* strictly foreclosing, then chooses to wholly ignore that requirement.

Had the Court of Appeals published the opinion, it is likely that fuller and more critical reasoning would have been employed but, instead, the court chose to use the shield of nonpublication to bury what was either a troubling or at least novel opinion away from public scrutiny and use — a practice that is totally at odds both with the rights of Petitioner and with society's right to access to opinions of the judiciary.

Finally, this Court should follow its rationale for granting certiorari in *Taylor v. McKeithen*, 407 U.S. 191, 32 L.Ed.2d 648, 92 S.Ct. 1980 (1972). There, in a case involving reapportionment, the Court of Appeals had reversed the lower court without issuing an opinion. In granting certiorari, this Court noted that the "record does not fully inform us of the precise nature of the litigation and because we have not had the benefit of the insight of the Court of Appeals, we grant the petition for writ of certiorari . . ." *Taylor*, 407 U.S. at 194. Although the Court, in a footnote agrees that courts of appeal *generally* "have wide latitude in their decisions of whether or how to write opinions," it also recognized that circumstances can arise which make that decision an abuse of discretion and warrant intervention by this Court. *Id.* at n. 4.

Similarly, in the instant case, the unpublished opinion gives little insight into the rationale the Ninth Circuit used to reach this questionable decision. Thus, the petition for writ of certiorari should be granted so that the issues involved in this case can be thoroughly analyzed, and the

rights of the appellant properly addressed, and so that this Court can provide guidance to the lower courts as to the proper uses and abuses of the practice of non-publication.

2. Section 9-505(2), Requires That The Secured Party Be In Actual Possession Of The Collateral, And Does Not Apply To General Intangibles, Which Are Per Se Incapable Of Being Possessed, And A Uniform Application Of This Section Is Necessary In Order To Facilitate Interstate Commerce:

The reason for the Ninth Circuit's disinclination to publish the Memorandum seems clear. As discussed more fully below, such a decision would be bad law and run contrary to the actual intent of the drafters of the Uniform Commercial Code so it should not be allowed to stand as a precedent. In other words, this was a "result" oriented decision, with the Ninth Circuit deciding who it thought should win and then coming up with a rationale to support that determination. This is such a radical departure from the "accepted and usual course of judicial proceedings" that this Court should put a stop to the practice.

Moreover, one of the primary goals of the UCC is to create a *uniform* set of commercial law so that anyone transacting business in one of the states which have adopted the UCC will have the same, or at least similar, rights and obligations in the other states which have adopted it, thereby easing the flow of interstate commerce. UCC Section 1-102(2). *See Connolly v. Bank of Sonoma*, 184 Cal.App.3d 1119, 1125 (1986); *See also Los Angeles Nat'l Bank v. Bank of Canton*, 229 Cal.App.3d 1267, 1278 (1991), quoting *United States Fid. & Guar. v. Federal Reserve Bank*, 620 F.Supp. 361, 370 (S.D.N.Y. 1985) for the proposition that, in terms of its basic purpose: "The UCC . . . was designed to facilitate commerce primarily by

guiding and making predictable the consequences of behavior."

Section 9-505 makes available, under certain conditions and in certain circumstances, the remedy of "strict foreclosure" which was sometimes available under common law. Under strict foreclosure, the secured party retains the collateral in full satisfaction of the debt. Section 9-505(1) provides for strict foreclosure with respect to certain consumer goods, and Section 9-505(2) provides that:

> In any other case involving consumer goods or any other collateral *a secured party in possession* may, after default, propose to retain the collateral in satisfaction of the obligation. Written notice of such proposal shall be sent to the debtor if he has not signed after default a statement renouncing or modifying his rights under this subdivision. In the case of consumer goods no other notice need be given. In other cases notice shall be sent to any other secured party from whom the secured party has received (before sending his notice to the debtor or before the debtor's renunciation of his rights) written notice of a claim of an interest in the collateral. If the secured party receives objection in writing from a person entitled to receive notification within 21 days after the notice was sent, the secured party must dispose of the collateral under Section 9-504. In the absence of such written objection the secured party may retain the collateral in satisfaction of the debtor's obligation. (Emphasis added.)

Cal. Com. Code Section 9505(2) (West 1990) (identical to U.C.C. Section 9-505(2)) (section references hereinafter are to the Uniform Commercial Code (the "UCC" or "Code"), upon which the California Commercial Code is adopted, unless otherwise indicated).

Section 9-505(2) requires (i) a default, (ii) the secured party to be in possession of the collateral, (iii) the secured

party to send the debtor, and in some cases any other secured party, a written notice that it proposes to retain the collateral in full satisfaction of the debt, and (iv) that the debtor or any party entitled to notice of the proposal must be given twenty-one days after the proposal to object. If all requirements are met and no timely objection is made, then the secured party may retain possession of the collateral in full satisfaction of the debt, and the debtor loses any equity it may have in the collateral. If the secured party is not in possession or fails to give the required notice of proposal to the debtor, or if a party entitled to notice objects, then the secured party must sell the collateral in a commercially reasonable manner pursuant to Section 9-504 and remit any proceeds in excess of the debt to the debtor. The requirements and rights granted under the section cannot be waived prior to default.

This case involves precisely the type of harm that the UCC and the courts have historically striven to prevent: To secure a loan of only $350,000, Hafif took as collateral Debtor's 2 Points, a general intangible, which the Bankruptcy Court found to be worth $1.4 million at the time of Hafif's purported strict foreclosure.

Hafif attempted to have Debtor waive his rights in the Note, a waiver that the law does not permit. Upon default, Hafif did not either judicially or non-judicially foreclose upon the collateral but rather claimed to have obtained title to it by virtue of the legally ineffective waivers in the Note — notwithstanding the fact that Debtor had equity in the collateral in excess of $1,000,000.

It was only after Hafif was sued by Debtor to recover damages for his violation of Article 9 of the California Commercial Code that Hafif claimed that it had really attempted a strict foreclosure of that collateral pursuant to Section 9-505(2). This claim is without merit because the 2 Points, which are general intangible by definition cannot

be possessed for the purpose of a "strict foreclosure" under Section 9-505(2). Even if a strict foreclosure of a general intangible were possible, Hafif completely circumvented the absolutely essential protections provided by Section 9-505(2) by failing to actually propose a strict foreclosure in writing and instead simply stating that the foreclosure was final, without providing Debtor with his statutory opportunity to object.

It is worth noting that, rather than foreclosing upon the 2 Points pursuant to Section 9-504 and remitting the excess proceeds to Debtor, as required under that section, after Hafif received Debtor's objection, Hafif's employee wrote back to inform Debtor that Hafif was "a little bit furious" that Debtor had objected, that Hafif owned the 2 Points, and that if Debtor wanted the 2 Points he would have to purchase them at a premium. In essence, Hafif attempted to unlawfully coerce Debtor into relinquishing all of his interest in the 2 Points, worth $1.4 million, in full satisfaction of a loan of $350,000.

Although the lower courts, and the Ninth Circuit by its affirmance, ruled that Hafif could and did properly foreclose on the 2 Points, these rulings were clearly contrary to the law, violating the default provisions of Article 9 of the Uniform Commercial Code.

A. Sections Of The Code That Require The Secured Party To Be In Possession Do Not Apply To General Intangibles:

Both of the lower courts and the Ninth Circuit recognized that a formal requisite of "strict foreclosure" under Section 9-505(2) is that the secured party must be in "possession" of the collateral. (Judgment, Appendix at 5a; Order, Appendix at 15a-16a; memorandum, Appendix at 23a-24a). In contrast, Section 9-504, which governs foreclosure sales, has no possession requirement, and the secured party may

therefore sell collateral it cannot possess pursuant to Section 9-504.

Section 9-505(2) is not available to Hafif in this case as its collateral is a general intangible that is not capable of being possessed as required by the section. As described in the Note, the collateral is an undivided beneficial interest in a trust and falls within the definition of a "general intangible" under Section 9-106. Section 9-106 defines general intangibles as: "... any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money." The Bankruptcy Court expressly agreed that the "interest in the trust is a general intangible and ... that a general intangible cannot be possessed in the usual sense." (Judgment, Appendix at 5a). However, the Bankruptcy Court held that: "... while the Plan may not have had actual possession of the collateral, it had sufficient dominion and control over it to constitute possession, for purposes of this section." (Judgment, Appendix at 6a). The District Court and the Ninth Circuit adopted this holding, with the District Court actually contending that nothing in the Code or its comments expressly precluded applying Section 9-505(2) to general intangibles. (Order, Appendix at 16a).

This holding is contrary to the law. The Official Comments to the UCC expressly state that by definition a general intangible cannot be "possessed." For example, the UCC Official Reasons For 1977 Changes to Section 9-305 states that an uncertificated security, which is a general intangible under Section 9-106: "... by definition, cannot be 'possessed.' " Thus, the drafters of the UCC have made clear that a general intangible is an interest that is not capable of being possessed.

More importantly, the drafters designed the Code such that provisions that applied only to secured parties in possession would not apply to general intangibles. Thus, none of

the sections in Article 9 requiring the secured party to be in possession, e.g., sections 9-203, 9-207, 9-305 and 9-503, would apply to property that could not be possessed (such as accounts receivable and general intangibles). The Code has always distinguished between so-called "possessory" and "nonpossessory" security interests.

One example is Section 9-203(1)(a), which is the statute of frauds section of Article 9. Section 9-203(1)(a) provides that "a security interest is not enforceable against the debtor or third parties with respect to the collateral . . . unless . . . (a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral . . .

With regard to this statute of frauds section which distinguishes between possessory and non-possessory security interests, Official Comment 3 to Section 9-203 states:

> One purpose of the formal requisites stated in subsection (1)(a) is evidentiary . . . Where the collateral is in the possession of the secured party, the evidentiary need for a written record is much less than where the collateral is in the debtor's possession; customarily, of course, as a matter of business practice the written record will be kept, but, in this Article as at common law, the writing is not a formal requisite. Subsection (1)(a), therefore, dispenses with the written agreement — and thus with signature and description if the collateral is in the secured party's possession.

Another example is Section 9-305 which sets forth the types of property in which a security interest may be perfected by the secured party's possession. Official Comment 1 to Section 9-305 makes clear that the section does not apply to property that could not be possessed:

> This Section permits a security interest to be perfected by transfer of possession only when the collateral is

> goods, instruments (other than certificated securities, which are governed by Section 8-321), documents or chattel paper: that is to say, *accounts and general intangibles are excluded*... A security interest in accounts and general intangibles — property not ordinarily represented by any writing whose delivery operates to transfer the claim — may under this Article be perfected only by filing, and this rule would not be affected by the fact that a security agreement or other writing described the assignment of such collateral as a "pledge." (Emphasis added.)

Further, Official Comment 5 to Section 9-302, which sets forth when filing is required to perfect a security interest, states:

> This Article adopts the filing requirement [for accounts receivable], on the theory that there is no valid reason why public notice is less appropriate for assignments of accounts than for *any other type of nonpossessory interest.* Section 9-305, furthermore, excludes accounts from the types of collateral which may be the subject of a possessory security interest: filing is thus the only means of perfection contemplated by this Article. (Emphasis added.)

The possession requirement with respect to perfection under Section 9-305, which does not apply to general intangibles, is analogous to the possession requirement of Section 9-505(2). As will be discussed in more detail below, the possession requirement in both sections serves to notify third parties of the secured creditor's interest in the property. Just as perfection by "possession" of a general intangible is not possible under Section 9-305, strict foreclosure of a general intangible is not possible under Section 9-505(2). For example, a general intangible such as goodwill in a company could not be possessed for purposes of perfection or strict foreclosure, and thus perfection by possession and

strict foreclosure cannot be available options. Rather, a secured party would have to file pursuant to Section 9-302 in order to perfect its interest in the general intangible and could only foreclose by selling the general intangible pursuant to Section 9-504.

It is also important to note that this result is unchanged simply because, as the Official Comment to Section 9-305 confirms, a description of the general intangible can be reduced to writing or some permanent form. *See, e.g., In the Matter of Information Exchange, Inc.*, 98 Bankr. 603 (Bankr. N.D. Ga. 1989) (possession of computer tapes was insufficient to perfect a security interest in a computer program (a general intangible), as the tapes did not provide adequate notice to third parties of the secured party's interest in the program).

In their decisions, both the lower courts and the Ninth Circuit failed to recognize that Section 9-305 does not apply to property that cannot be possessed, and blurred the fundamental distinction between sections that require the secured party to be in possession and those that do not. The District Court contented itself with observing that the comments to that Code section state that a security interest in a general intangible can only be perfected by a writing and, here, the trustee of the Marriner Note Trust had written Hafif *prior* to the default to acknowledge: "that Debtor had 'transferred an interest' in the trust and [the trustee] agreed to 'act in accordance with writings from [Hafif] regarding disposition of said two percent undivided beneficial interests.' " (Order, Appendix at 16a). Thus, the courts below missed the point of these sections of the UCC entirely.

For their part, the Bankruptcy Court and the Ninth Circuit relied on *Kruse, Kruse & Miklosko, Inc. v. Beedy*, 353 N.E.2d 514, 20 UCC Reporting Service 217 (Ind. 1976), for the authority that a secured party takes possession of collateral for the purposes of strict foreclosure by

notifying the bailee holding the collateral of the secured party's interest. *Kruse* involved a pledge of capital stock of a corporation which was in the possession of the bailee, and the court in *Kruse* relied on the definition of possession as applied to perfection of security interests under Indiana Commercial Code Section 26-1-9-305, which is the equivalent of UCC Section 9-305. The court in *Kruse* properly applied the section to capital stock, which is not a general intangible but instead an "instrument" as defined in Section 9-105(1)(i) that is capable of being possessed and was in fact possessed by the bailee.

However, by relying on the analysis in *Kruse,* the Bankruptcy Court and the Ninth Circuit were, in effect, applying Section 9-305 to a general intangible, despite the fact that, as discussed above, Section 9-305 does not apply to general intangibles. *Kruse* and Section 9-305 are not applicable to general intangibles, and their reliance on *Kruse* as authority for its decision was misplaced.

The importance of the distinction between possessory and non-possessory security interests was also demonstrated by the Code draftsmen who determined, at the time they formulated the 1977 revisions to the Code dealing with "uncertificated" securities, that certain provisions of a section of Article 9 that apply only in situations where the secured party is in possession could, by means of a drafting technique in a new provision in Article 8, make the Article 9 provisions applicable to "nonpossessory" and "non-possessed" interests dealt with in the new provision in Article 8. To elaborate: the Official Text of the UCC was amended in 1977 to put into Article 8 those provisions, formerly in Article 9, that govern the creation and perfection of security interests in both certificated (i.e., stock) and uncertificated (i.e., "book entry") securities. At the same time, a provision in Article 9, Section 9-207, which sets forth the rights and obligations of a secured party *in possession* of collateral,

was, by virtue of new Section 8-321(3)(b), expressly made applicable to securities now governed by Article 8, thereby avoiding the necessity of repeating the provisions of Section 9-207 in Article 8. Section 8-321(3)(b) states, in part:

> The secured party has the rights and duties provided under Section 9-207, to the extent they are applicable, whether or not the security is certificated, and if certificated, whether or not it is in his possession.

The language in Section 8-321 expressly distinguishes between uncertificated securities (which are general intangibles under Section 9-106) and certificated securities — in order to specifically include both "nonpossessory" uncertificated securities and "non-possessed" certificated securities within the scope of Section 9-207. Section 9-207 otherwise only applies to property in possession of the secured party, and without this express language in Section 8-321, Section 9-207 would not be deemed to apply to uncertificated securities. Section 8-321 likewise expressly "deemed" Section 9-207 to include certificated securities *not in possession*, which also would otherwise not be included in the section. Given this explicit language in Article 8 to expand the scope of Section 9-207 to include certain general intangibles, the drafters of the UCC were indeed demonstrating that without such additional language, general intangibles would not be covered by that section or any other section that requires possession.

Of further significance is the lack of any reference in Section 8-321 to Section 9-505(2). The drafters did not extend the scope of Section 9-505(2) to include general intangibles such as uncertificated securities, even though they clearly understood the necessity of doing so in the context of Section 9-207. Thus, neither general intangibles consisting of book entry securities nor certificated securities not in the secured party's possession are subject to strict foreclosure under Section 9-505(2). The same result neces-

sarily follows with respect to a general intangible consisting of a beneficial interest in a trust, as is involved in this case.

Apparently, the drafters of the UCC are not the only ones who understand that a section that requires the secured party to be in possession of its collateral does not apply when the collateral is not capable of being possessed, such as a general intangible. Although the Uniform Commercial Code has been in effect for several decades now, and Section 9-505 was adopted by California effective January 1, 1976, there is no reported case in which a *secured party* has even attempted a strict foreclosure of an intangible under Section 9-505(2) — or under any comparable statutory or common law provision — let alone a case in which such a strict foreclosure was held to be possible.

In *In re Emergency Beacon,* 48 Bankr. 341 (S.D.N.Y. 1985), relied upon in the District Court's Order, the debtor (*not* the secured party) claimed that the secured party had strictly foreclosed on accounts receivable and hence that the debt should be deemed satisfied under Section 9-505(2). The court's opinion was completely silent, though, as to the issue of whether section 9-505(2) applied to accounts receivable as the court held that the secured party never gave notice to the debtor that it proposed to accept the accounts in full satisfaction of the debtor's obligation. *Id.* at 347.

Although not specifically cited in the Memorandum, *Emergency Beacon* was argued in Hafif's Briefs and the District Court had found this case to be of great significance in supporting its conclusion that a secured creditor could strictly foreclose on a general intangible but this was based on its erroneous belief that an account receivable was a general intangible. In point of fact, Section 9-106 expressly excludes accounts from the definition of a general intangible and the court in *Emergency Beacon* therefore did not address the question whether an intangible could be possessed for purposes of Section 9-505(2). 48 B.R. at 344. That court

did observe, however, that Section 9-505(2) could not be satisfied because the secured lender had never given written notice to the debtor. *Id.* at 347. This holding is readily understandable as the collection of accounts is governed by Section 9-502, not the strict foreclosure provisions of Section 9-505.

B. The Possession Requirement Is An Essential Element Of Strict Foreclosure And Should Not Be Read Out Of The Statute:

The possession requirement in Section 9-505(2) has its basis in the common law preceding the UCC and serves an essential function. Under the common law, possession of the collateral by the secured party was necessary to notify third parties that the debtor was in default and that the secured party had assumed ownership of the collateral. *See. e.g., Stanley v. The Citizens Coal And Coke Co.*, 24 Colo. 103, 49 P. 35 (1897); *Shannon v. Wolf*, 173 Ill. 253, 50 N.E. 682 (1898). Without possession by the secured party or a foreclosure sale, third parties could not know that the debtor no longer had an interest in the property and that the secured party was the owner. In a strict foreclosure, the secured party *retains* the collateral and would generally not have to seek additional court approval in order to enforce its right to possess, use or dispose of the collateral. The secured party's actual and permanent possession served to notify third parties that ownership had indeed changed hands.

No attempt to "possess" a general intangible can meet this essential element of strict foreclosure. Not only can a general intangible not be possessed in any physical sense as conceded by the Bankruptcy Court (*see* Judgment, Appendix at 5a) *and* by the Ninth Circuit, but it also cannot be "possessed" in any manner sufficient to serve the world with notice of the change of ownership. As set forth in Sections 9-302 and 9-305 and the Official Comments to the

UCC, in order to perfect a security interest in a general intangible, nothing short of filing a financing statement with the appropriate authorities is sufficient to notify the world that the secured party has acquired an interest in the general intangible. Likewise, no efforts to "possess" a general intangible — not writing a letter, notifying a trustee of a claimed interest (such as Hafif did as evidenced by the October 11, 1984 letter from the employee of the trustee of the Marriner Note Trust) or holding a document describing the interest — is sufficient to constitute "possession" as required to notify the world that a strict foreclosure has occurred and that ownership has changed.

The lower courts and the Ninth Circuit failed to address this critical purpose behind the possession requirement of Section 9-505(2) when they ruled that "dominion and control" over a general intangible was sufficient. (*See* Judgment, Appendix at 6a; Order, Appendix at 16a). In effect, the courts read the possession requirement out of the statute or waived its application with respect to a general intangible. This is not permissible.

Just as such a reading is implausible with respect to perfection by possession, this interpretation of the possession requirement is implausible with respect to a strict foreclosure. Section 9-505(2) expressly requires a secured party to be in possession of the collateral and cannot apply when the collateral is not, or cannot be, possessed. *See McIlroy Bank & Trust v. Seven Day Builders of Arkansas, Inc.* 1 Ark.App. 121, 132-33; 613 S.W.2d 837, 842 (Ark. Ct. App. 1981) (noting that there could not be a strict foreclosure if the secured party was not in possession of the collateral at the time the letter purportedly electing that remedy was sent).

C. The Harshness Of Strict Foreclosure As A Remedy Mandates That Section 9-505 Should Not Be Expanded Beyond Its Express Language:

Historical accounts of mortgage foreclosures of personal property describe strict foreclosure as having once been the natural remedy in the event of a default. *See* II Grant Gilmore, *Security Interests in Personal Property* Section 43.2 (1965). This flowed from the view that the conveyance of a mortgage vested title in the mortgagee, and foreclosure was akin to an action to quiet title. *See Warner Bros. Co. v. Tiny Freud*, 138 Cal. 651, 72 P. 345 (Cal. 1903). As such, the mortgagor would forfeit title and any interest in the property upon strict foreclosure. Because of the inherent harshness of strict foreclosure to the mortgagor, by the first half of the nineteenth century the practice of strict foreclosure nearly disappeared. *See* II Gilmore Section 43.2. The courts adopted the view that a mortgage represented a mere security for the debt and did not vest title in the mortgagee, and in this manner the mortgagor was entitled to any proceeds from the sale of the land that exceeded the amount of the debt. *See id.; Warner Bros.*, 138 Cal. at 651.

California did not allow strict foreclosure of mortgages on land under any circumstances. *See* John Hanna, *Cases and Other Materials on Security* 864 (1932). Likewise, a provision in a chattel mortgage granting the mortgagee the right to take possession of the chattel upon default and retain the property in satisfaction of the debt was deemed void in California. *Wakabayashi v. Stafford Packing Co.*, 186 Cal. 632, 200 P. 392 (Cal. 1921). While a few states allowed some form of strict foreclosure before the adoption of the UCC, they were in the distinct minority. *See* II Gilmore Section 43.2. Thus, the enactment of Section 9-505(2) in the California Commercial Code created a new,

but limited, strict foreclosure remedy for secured parties that was not theretofore available.

Under the UCC, strict foreclosure continues to be a harsh remedy. Unlike a foreclosure sale under Section 9-504, if the secured creditor complies with Section 9-505(2), the debtor is not entitled to recover any proceeds in excess of the debt, and a strict foreclosure has no counterpart to the commercial reasonableness requirement that exists in the case of a foreclosure sale. The remedy of strict foreclosure is available under Section 9-505(2) because in certain circumstances *both* parties may decide that they are better off if the secured party retains the collateral in exchange for relieving the debtor from any further obligation on the debt. *See* U.C.C. Section 9-505 Comment 1 (West 1990). However, because of the inherent harshness of strict foreclosure should the debtor have equity in the property, the protections afforded the debtor in terms of entitlement to a notice that the secured party proposes to retain the collateral under Section 9-505(2) and the opportunity to object are essential to counterbalance these harsh effects.

The harshness of the remedy of strict foreclosure is readily apparent in the case at hand. Were Section 9-505(2) applicable to general intangibles, Debtor would lose the benefit of a foreclosure sale executed in a commercially reasonable manner pursuant to Section 9-504 and forfeit any proceeds that could have been obtained in excess of the amount of the debt. The Bankruptcy Court acknowledged the validity of the testimony presented by Debtor regarding the value of the 2 Points and that they had considerable value in excess of the amount of the debt. (Judgment, Appendix at 8a). The difference between the value of the 2 Points and the amount due on the note exceeded $1 million, and this loss does not include the interest Debtor would have earned on the excess proceeds that would have been

remitted to him had Hafif bothered to comply with the provisions of the Uniform Commercial Code.

The UCC severely limits the application of strict foreclosure for the very purpose of avoiding the type of harm that occurred in this case. Section 9-505(2) provides that the secured party may only propose a strict foreclosure and give the debtor twenty-one days within which to object. If the debtor objects, then the secured party *must* proceed by means of a foreclosure sale pursuant to Section 9-504. Thus, the debtor has absolute veto power with respect to a strict foreclosure.

The Bankruptcy Court, by holding that Section 9-505(2) applies to collateral that cannot be possessed, expanded the scope of the section beyond its language and intent. The District Court and the Ninth Circuit have ratified this view, albeit in unpublished decisions. Given the harshness of strict foreclosure, the severe limitations on strict foreclosure in the UCC and the historical distaste courts have had for this remedy, the scope of strict foreclosure should not be expanded beyond the Code's express language and intent, especially when the debtor will forfeit a substantial interest in the collateral.

III.

CONCLUSION

For the foregoing reasons, this Court should issue a Writ of Certiorari to review the Judgment of the United States Court of Appeal for the Ninth Circuit.

Dated: June 8, 1994

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